

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-3770-99

AJMandell

date:

to: Chief, Examination Division, Brooklyn
Attn: Group Manager, Mike McEnerney
Norman Lieberman, Team Coordinator

from: District Counsel, Brooklyn

subject:

U.I.L. 355.01-00; 108.04-05

THIS DOCUMENT MAY INCLUDE CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATE PROCESS PRIVILEGES, AND MAY ALSO HAVE BEEN PREPARED IN ANTICIPATION OF LITIGATION. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT IN RELATION TO THE MATTER OF THE CASE DISCUSSED HEREIN. THIS DOCUMENT IS ALSO TAX INFORMATION OF THE INSTANT TAXPAYER WHICH IS SUBJECT TO I.R.C. § 6103.

Issues:

1. Whether the taxpayer qualified for a tax free spin-off under I.R.C. section 355?
2. Whether the taxpayer can charge-off to retained earnings intercompany loans of \$[REDACTED] or whether the intercompany writeoff is cancellation of indebtedness income pursuant to I.R.C. section 108?
3. If the taxpayer does qualify for a tax free spin-off, whether I.R.C. section 301(c)(3)(A) would apply to the portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock?

Facts:

The facts, as we understand them from the information you provided, are as follows:

[REDACTED] is a manufacturer of [REDACTED] equipment. It was incorporated in the [REDACTED] by [REDACTED] who was its sole shareholder. When he died, his son [REDACTED] became the sole shareholder. In the [REDACTED], [REDACTED] expanded its business through stock and asset

AJMandell

acquisitions. It acquired manufacturing as well as service businesses including [REDACTED]. Prior to the spin-off, to be discussed below, all subsidiaries of [REDACTED] were 100% owned by [REDACTED] and filed consolidated returns.

In [REDACTED], [REDACTED] had some cash flow problems, and turned to [REDACTED] for financing. The minutes of the board of directors of [REDACTED], dated [REDACTED], indicate that the company had received a proposal from [REDACTED] to establish a \$[REDACTED] secured term loan and a revolving credit line, the proceeds of which would be available for corporate purposes, and which would be used by the company and its individual subsidiaries to repay existing loans.¹

It was further indicated in the minutes that [REDACTED]'s proposal was contingent upon the company divesting itself of two of its wholly-owned subsidiary corporations which did not conduct manufacturing operations. According to the minutes, the first of the subsidiaries was [REDACTED] which conducts various services, either directly or through its wholly-owned subsidiaries, [REDACTED], [REDACTED], and [REDACTED]. The other subsidiary was [REDACTED].²

[REDACTED] stated that the major refinancing was necessary because the company's existing bank lenders had imposed a [REDACTED] termination date on the company's existing lending facilities.

The taxpayer provided a commitment letter dated [REDACTED] and an excerpt from the [REDACTED] agreement. The commitment letter provided that the loan was subject to the spin-off of certain 'non-core' assets in a manner satisfactory to them. The [REDACTED] financing agreement provided that the service companies should have been completely divested as direct or indirect subsidiaries of [REDACTED] prior to the closing date, and in conjunction with such divestiture the companies should not have retained or assumed any of the liabilities thereof.

[REDACTED] went on to state that [REDACTED] and [REDACTED] have in

¹We are relying on the agent's summary of the minutes of the board of directors, as copies of the minutes were not submitted to us for our review. The statements attributable to [REDACTED] and [REDACTED] were taken solely from the corporate minutes of the taxpayer.

²The letter from [REDACTED] to [REDACTED], dated [REDACTED] which set forth the conditions of the loan, required "the spin-off of certain 'non core' assets in a manner satisfactory to us."

the past had access to the financial resources of the company [REDACTED], and in order to enhance the viability of [REDACTED] and [REDACTED] as independent companies, it would be advisable to contribute to them all indebtedness owed by them to the company.

According to [REDACTED], Senior Vice President and Chief Financial Officer of [REDACTED] and [REDACTED], the debt of [REDACTED] and [REDACTED] to [REDACTED] was outstanding in the aggregate amount of approximately \$[REDACTED].³ In his opinion, it would be difficult or impossible for [REDACTED] to repay these obligations in the foreseeable future from its operating revenues.

The intercompany loan between [REDACTED] and [REDACTED], in the amount of \$ [REDACTED], was forgiven immediately prior to the spin-off⁴ and reclassified as additional paid in capital. This forgiveness of indebtedness changed the total net worth of [REDACTED] and its subsidiaries.

The consolidated financial statements of [REDACTED] states that "[REDACTED]

Journal entries in [REDACTED]'s books at the time of the spin-off indicate that the taxpayer wrote off the intercompany debt to the retained earnings account. The subsidiary's books reclassified this debt to additional paid in capital.

In the agent's opinion it appears that [REDACTED] is taking on more debt in order to capitalize and increase the net worth of its former subsidiaries for the benefit of its sole shareholder, [REDACTED]

Based upon an analysis of the balance sheets of [REDACTED] [REDACTED] has never made a profit since its existence, and the losses have been fully absorbed by [REDACTED].

Discussion:

3This included a \$[REDACTED] note of [REDACTED] payable to [REDACTED] in his individual capacity.

'A spin-off is a distribution to stockholders by one corporation of the stock of a controlled subsidiary without the recipients' surrender of their stock in the transferor.

Issue 1: Whether the taxpayer qualified for a tax free spin-off under I.R.C. section 355?

Section 355 provides, in pertinent part, that if a corporation distributes to a shareholder, with respect to its stock, solely stock of a corporation which it controls immediately before the distribution; the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both; the distributing corporation, and the controlled corporation are engaged immediately after the distribution in the active conduct of a trade or business; and as part of the distribution the distributing corporation distributes all of the stock and securities in the corporation held by it immediately before the distribution, then no gain or loss shall be recognized to such shareholder.

The basis of the stock and securities received in a section 355 spin-off is determined with reference to the basis of the stock and securities held in the distributing corporation. The aggregate basis of the stock and securities in the distributing corporation is allocated on a fair market value basis between the stock and securities retained in the distributing corporation and the stock and securities received in the controlled corporation. I.R.C. section 358.

It is our understanding that there is no dispute that [REDACTED] distributed solely stock of controlled corporations; that the distributing corporation distributed all of the stock in the corporations held by it immediately before the distribution; and that both the distributing corporation and the controlled corporations were engaged in the active conduct of a trade or business as required by the regulations. Treas. Reg. section 1.355-3. The analysis, therefore, is focused on whether the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation. I.R.C. section 355(a)(1)(B).

Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes.⁵ Treas. Reg. section 1.355-2(b). The corporate business purpose is evidence that the transaction was not used principally as a device for the distribution of earnings and profits within the meaning of section

⁵The principal reason for this business purpose requirement is to provide non-recognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. Treas. Reg. section 1.355-2(b)(1).

355(a)(1)(B). Treas. Reg. section 1.355-2(b)(4).

A corporate business purpose is a real and substantial non-federal tax purpose germane to the business of the distributing corporation or the controlled corporation. Treas. Reg. section 1.355-2(b)(2). The Service has ruled that increasing the taxpayer's ability to conduct or finance its business would be considered a valid business purpose for the purpose of meeting the section 1.355-2(b) requirement. Rev. Rul. 85-122, 1985-2 C.B. 118. [REDACTED]'s corporate business purpose for the spin-off appears to be the ability to obtain new financing. The financing agreement with [REDACTED] provided that the service companies be completely divested as direct or indirect subsidiaries of [REDACTED] prior to the closing of the [REDACTED] loan. There is no indication that the taxpayer could have gotten a similar loan without distributing the stock of its controlled corporations.

If however, the corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation, and which is neither impractical nor unduly expensive, the separation is not carried out for a corporate business purpose. Treas. Reg. section 1.355-2(b)(3). However, to argue in this case that [REDACTED] could have accomplished this transaction without the spin-off by entering into a written agreement with [REDACTED] that no funds of the manufacturing entities would be used to finance any of the service entities, requires speculation. There is nothing to indicate that [REDACTED] would have been amenable to such an agreement.

There are a number of factors that should be considered before a determination is made as to whether tax free treatment should be afforded to a transaction.

I.R.C. section 355(a)(1)(B) provides that tax free treatment will not be afforded to a transaction that was used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation or both corporations. Factors that provide evidence of a device include a pro rata distribution; a subsequent sale or exchange of stock; and the presence of assets not used in a trade or business including cash and other liquid assets that are not related to the reasonable needs of a business. Treas. Reg. section 1.355-2(d)(2).

A factor that weighs against tax free treatment in the instant case would be that the distribution was pro rata. A distribution that is pro rata among the shareholders of the distributing corporation presents that greatest potential for the avoidance of the dividend provisions and is more likely to be used principally as a device. Treas. Reg. section 1.355-2(d)(2)(ii).

With regard to the remaining factors, it does not appear that there has been a subsequent sale or exchange of stock of the

distributing or the controlled corporation after the distribution, and there is no evidence of the existence of assets that are not used in the trade or business.

Factors that provide evidence that a transaction is not a device include a corporate business purpose for the transaction; that the distributing corporation is publicly traded and widely held; and that the distribution is made to domestic corporate shareholders. Treas. Reg. section 1.355-2(d)(3).

Although the taxpayer's stock is not widely held or publicly traded, the distribution was made to domestic shareholders, and as discussed above, there appears to be a business purpose for the spin-off.

The determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including but not limited to, the presence of the device factors and nondevice factors listed above. Treas. Reg. section 1.355-2(d)(1). Although, as set forth above, the distribution was pro rata, and the taxpayer is not widely held or publicly traded, we believe that the fact that there appears to be a valid business purpose for the spin-off, would outweigh the other factors. Therefore, this would not be considered a device for the distribution of earnings and profits, and the taxpayer would be entitled to non-recognition treatment pursuant to section 355.

Issue 2: Whether the taxpayer can charge off to retained earnings intercompany loans of \$ [REDACTED] or whether the intercompany writeoff is cancellation of indebtedness income pursuant to I.R.C. section 108?

As set forth above, immediately prior to the spin-off, [REDACTED] wrote off the \$ [REDACTED] loan from [REDACTED] to the retained earnings account. On [REDACTED]'s books the debt was reclassified to additional paid in capital.

The discharge of indebtedness, in whole or in part, may result in the realization of income. I.R.C. section 61(a)(12). Treas. Reg. section 1.61-12(a) provides that, in general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal amount of the debt.

For transactions occurring after December 31, 1980, as is the case here, section 108(e)(6) provides that for purposes of determining the income from the discharge of indebtedness, if a debtor corporation acquires its debt from a shareholder as a

contribution to capital, section 118 does not apply.⁶ Instead, the debtor corporation is treated as having satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt. If the debt is treated as satisfied by an amount less than its adjusted issue price, the debtor corporation has cancellation of indebtedness income, subject to the limitations of section 108. I.R.C. section 108(e)(6)(B).

Section 108(e)(10)(A), as it existed prior to the Omnibus Budget Reconciliation Act of 1993, provides the general rule for exchanges of debt for stock that occurred between July 19, 1984 and December 31, 1994, inclusive, as is the case here. It provides that for purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of its stock.

It should be noted that when a parent cancels debt of a subsidiary in exchange for stock, the subsidiary would not be required to actually issue additional stock because to do so would be meaningless. Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); cert. denied, 368 U.S. 836 (1962); Rev. Rul. 64-155, 1964-1 C.B. 138. If the subsidiaries were deemed to issue stock in satisfaction of its debt to the parent, that stock would be treated as having a value equal to the value of the subsidiary debt which the parent canceled in exchange therefor. Moore-McCormack Lines, Inc. v. Commissioner, 44 T.C. 745 (1965).

We therefore do not believe, pursuant to either section 108(e)(6) or 108(e)(10)(A), that [REDACTED] should recognize cancellation of indebtedness income, to the extent of the principal amount of its debt, when the taxpayer canceled [REDACTED]'s debt. The cancellation of the debt appears to have been correctly reported by [REDACTED] as a contribution to capital.

Issue 3: If the taxpayer does qualify for a tax free spin-off, whether I.R.C. section 301(c)(3)(A) would apply to the portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock?

Pursuant to I.R.C. section 355(a), if the requirements of section 355 are met, then no gain or loss shall be recognized to the shareholders of the distributing corporation. Therefore, it is only if the requirements of section 355 are not met that the

⁶Section 118 holds that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

AJMandell

shareholders would be required to recognize gain. Under those circumstances, it would then be appropriate to apply I.R.C. section 301 to determine the characterization of the gain. Since we believe the transaction at issue is a tax free spin-off, section 301(c)(3)(A) would not apply.

If you have any additional questions, please call the undersigned at (516) 688-1701.

This opinion is based upon the facts set forth herein. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

DONALD SCHWARTZ
District Counsel
Brooklyn

By: _____

ANDREW J. MANDELL
Attorney